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Overview

Introduction

The purpose of this topic is to provide guidance in the performance of an economic analysis for leases.

The Department of Accounts (DOA) maintains a technical understanding of lease analysis methods and performs an analysis for agencies when requested. Agencies are encouraged to consult with DOA if questions arise, or to seek an opinion as to the adequacy of the analytical approach they intend to utilize.

Guidelines summarizing the economic analysis process are listed below.

Policy

General

Agencies must determine if the terms of a lease are favorable to the Commonwealth.

One method for making this determination is the performance of an economic analysis when deemed appropriate by the agency based upon materiality of the potential acquisition.

When undertaking an economic analysis, it is suggested that the following be considered:

- Cost benefit of preparing the analysis
- Internal procedures showing the conditions under which such an analysis will be made and,
- Documentation maintained that is related to the analysis.

Exception

An economic analysis is **not required** for equipment financed under the Treasury Board's Financing Program or the Higher Education Equipment Trust Fund administered by the Virginia College Building Authority (VCBA). Also, an analysis is not required when routinely entering into operating leases for office space since approval of the Bureau of Real Property Management (BRPM) of the Department of General Services is required. Complex transactions involving long term real property leases, having the characteristics of capital leases that are material in amount, are appropriate for analysis.

Procedures

Lease Analysis Request Forms

Whenever you would like assistance from DOA with lease classification, complete and submit a set of Lease Analysis Request forms (see CAPP Topic No. 70605, *LAS Input Documents*). Route the forms to the Assistant Manager, Disbursements Review and Assistance.

Lease Classification

The first step in the lease analysis process is to determine the classification of the proposed lease. The following four tests should be applied.

Test	Lease Classification
Title Transfer Test	The lease transfers ownership to the lessee by the end of the lease term.
Bargain Purchase Option test	The lease contains a bargain purchase option at the end of the lease term.
Lease Term Test	The lease term is equal to 75% or more of the estimated economic life of the leased property.
90% Payment Test [This test requires a present value computation with access to computer software or a calculator that performs present value functions.]	The present value of the minimum net lease payments equals or exceeds 90% of the fair market value of the property.

Capital or Operating Lease?

The following table explains how a lease is classified as capital or operating.

If…	Then the lease is classified as …
<u>any one</u> of the four tests is passed,	Capital
<u>none</u> of the four tests is passed,	Operating [Does not require further analysis.]

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Procedures, Continued

Capital Lease: Acquisition Methods

When the proposed lease is classified as a capital lease, additional steps should be performed to determine the best method of acquisition. Determine if

- the title passes to the lessee and
- the implicit interest rate is reasonable in order to determine the economic feasibility of the capital lease.

An economic analysis assists to make this decision and the preferred methods of acquisition are shown below.

Preferred Methods of Acquisition	Description
Purchase—Cash	Using current cash and appropriation
Purchase—Installment	Using an installment purchase plan wherein title passes immediately and the interest rate is reasonable.
Capital Lease—Title Passes	Where lease terms result in either transfer of ownership at some point after the inception of the lease or passage of title is expected as a result of a bargain purchase option and the implicit interest rate is reasonable.
Capital Lease—Title Does Not Pass	Where title does not pass. However, the value of the asset given up at the end of the lease term is deemed to be negligiible or immaterial and the implicit interest rate is reasonable.

Capital Lease: Title Passage

Generally, it is desirable for the lessee to take title to the asset in lease transactions having the substance of an acquisition (capital leases).

When either the

- **Title Transfer Test** or
- **Bargain Purchase Option Test** is met, an agency should enter into either of the following:
  - **Installment Purchase Agreement** where title passes immediately **or**
  - **Capital Lease** in which title will pass to the lessee.

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Procedures, Continued

When either the

- **Lease Term Test** or
- **90% Payment Test**

is met but title did not pass to the lessee, the lease may still be reasonable.

If the asset has little or no value at the end of the lease term, i.e., technological obsolescence or reached the end of its useful economic life, passing of title to the lessee is not an important issue.

Capital Lease: Implied Interest Rate

Determine the implicit rate of interest after establishing the best way for title to pass. You can do this by

- obtaining the rate from the vendor or lessor, or
- computing it.

Consider the following factors:

- Minimum Lease Payments
- Executory Costs
- Unguaranteed Residual Value
- Fair Market Value of Leased Asset

See CAPP Topic No. 31205—*Introduction*, for detailed definitions.

Analyze the implicit interest rate while considering comparability in which title may or may not pass. This involves

- estimating the value of the asset given up at the end of the lease term (when title will not pass) and
- factoring the present value of this amount into the payment stream as if it were an additional payment at the end of the lease.

The resulting rate may then be compared to the implicit interest rate for a transaction in which title will pass to the lessee. If the value of the asset at the end of the lease is negligible, it may be ignored in the computation.

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Procedures, Continued

Implicit Interest Rate Comparison

Once the implicit interest rate has been determined, compare it to a reasonable standard, such as

- Incremental Borrowing Rate (published prime rate at the time the proposed is under consideration), or
- Treasury Board Financing Program Rate.

For the proposed lease or installment purchase to be considered favorable, the Implicit Interest Rate should <u>not be materially in excess of</u> the either of these rates.

Requesting DOA for Rate Analysis

This rate calculation requires a present value computation with access to computer software or a calculator that performs present value functions.

Whenever you would like assistance from DOA with **Implicit Interest Rate calculation**, complete and submit a set of Lease Analysis Request forms (see CAPP Topic No. 70605, *LAS Input Documents*). Route the forms to the Assistant Manager, Disbursements Review and Assistance.

Unfavorable Lease Terms

If the above analysis indicates the terms of the proposed lease are unfavorable, i.e., interest rate is high and/or title is not to pass, the agency may still want to proceed with the transaction. In such cases, this requires approval in writing from the agency head or other responsible person to whom this authority has been delegated.

Internal Control

General

Each agency and institution should implement cost-beneficial, internal control procedures to ensure that:

- Procedures exist indicating when an economic analysis should be performed.
- Every effort is made to obtain favorable rates of interest in the lease or installment purchase.
- Agency head or designee approval is obtained for all leases shown to have unfavorable terms.
- Interest rates are compared to incremental borrowing rates and Treasury Board Financing Program rates.
- Treasury Board approval is obtained for alternative financing arrangements for items exceeding prescribed limits.

Records Retention

General

Fiscal records related to managing fixed assets should be retained for a period of 2 years plus current fiscal year, or until audited, whichever is greater. However, for pending, ongoing, or unresolved litigation, audits or claims, retain documentation until completion, resolution, or negotiation of settlements.

Destruction of records must be in accordance with policies and procedures of the Records Management Section, The Library of Virginia.

DOA Contact

Contact

Assistant Director, Fixed Assets and Indirect Cost
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Subject Cross References

References

CAPP Topic No. 31205—*Introduction*

CAPP Topic No. 70605—*Data Entry*